BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
MARTIN S. AND AUDREY B. APPEL, et al.)

For Appellants: Martin S. Appel
Attorney tit. Law

For Respondent: Bruce W. Walker
Chief Counsel

Brian W. Toman
Counsel.

O P I N I O N

These appeals are made pursuant to section 18593 of the Revenue and Taxation Code from the actions of the Franchise Tax Board on the protests of Martin S. and Audrey B. Appel, Joe and Irene Benaron, Stephen M. and Patricia S. Rucker, and Murray and Janet Cowan against proposed assessments of additional personal income tax in the amounts of $753.84, $4,174.30, $216.20, and $4,046.40, respectively, for the year

1971. Subsequent to the filing of this appeal, Murray and Janet Cowan paid their proposed assessment in full. Accordingly, pursuant to section 19061.1 of the Revenue and Taxation Code, their appeal is treated as an appeal from the denial of a claim for refund.

The issue to be decided is whether appellants' exchange of stock in one corporation for the stock of another corporation was a tax-free exchange under Revenue and Taxation Code section 17431, preventing appellants from recognizing losses on the transaction.

Appellants, in 1971, were all shareholders in Lectrabed Corporation ("Lectrabed"). Appellants Benaron and Cowan were also shareholders in Wilshire Bedding Company, Inc. ("Wilshire"), each owning 44.44 percent of the stock of that company, In September 1971, Wilshire offered to acquire Lectrabed in exchange for debentures or stock or some combination of those. Most of the Lectrabed shareholders elected to take the Wilshire stock, exchanging 2.66 shares of Lectrabed for each Wilshire share. For purposes of the exchange, the Lectrabed shares were valued at about 75 percent of their original cost to the Lectrabed shareholders.

Before the exchange, Benaron and Cowan together owned 88.88 percent of the Wilshire stock. After the exchange, together they owned 77.72 percent of Wilshire, since they had smaller interests in Lectrabed and new shares were issued for the exchange. The other Lectrabed shareholders owned a total of 13.28 percent of Wilshire after the exchange, making all the Lectrabed transferors together the owners of 91 percent of Wilshire immediately after the exchange.

Since the Lectrabed stock was valued at less than appellants' basis, they claimed losses on their 1971 returns, treating them as ordinary losses pursuant to the small business stock provisions of Revenue and Taxation Code sections 18204 through 18210. Respondent disallowed the losses, contending that the transaction was a tax-free exchange under Revenue and Taxation Code section 17431, and therefore no gain or loss could be recognized.

Since section 17431 is the same as Internal Revenue Code section 351, federal case law and interpretations are highly persuasive in the construction of the California section. (Holmes v. McColgan, 17 Cal. 2d 426, 430 [110 P. 2d 428] (1941); Rihn v. Franchise Tax Board, 131 Cal. App. 2d 356, 360 [280 P. 2d 893] (1955).) These sections provide that if property is transferred to a corporation by one or more persons solely in exchange for stock or securities of such corporation, and immediately after the exchange such person or persons are in control of the corporation, no gain or loss shall be recognized. "Control" is defined as the ownership

of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. (Rev. & Tax. Code, § 17463; Int. Rev. Code, § 368(c).)

Here, appellants exchanged property (Lectrabed stock) solely for stock in Wilshire, and immediately after the exchange the transferors as a group owned more than 80 percent of Wilshire. On its face, therefore, the transaction is a tax-free exchange under section 17431. That section and its federal counterpart are not optional provisions, to be used or not as the taxpayer desires. If the proper facts are present, no gain or loss is recognized, regardless of whether the parties intended that result. (Gus Russell, Inc. , 36 T. C. 965, 969 (1961).) Where property is transferred to a controlled corporation solely for stock or securities, "it is difficult to see how the parties can avoid [section 17431]." (Bittker and Eustace, Federal Income Taxation of Corporations and Shareholders (4th ed. 1979) ¶ 3.15, p. 3-61.)

Appellants, however, contend that the interests of Benaron and Cowan, who were Wilshire shareholders before the exchange, should not be counted in determining whether the transferors were in control immediately after the exchange. Their primary argument for this contention is based on a part of the regulation for section 17431, which states:

> (ii) Stock or securities issued for property which is of relatively small value in comparison to the value of the stock and securities already owned (or to be received for services) by the person who transferred such property, shall not be treated as having been issued in return for property if the primary purpose of the transfer is to qualify under this section the exchanges of property by other persons transferring property. (Cal. Admin. Code, tit. 18, reg. 17431(a), subd. (1)(A)(ii).)

Identical language is contained in the federal counterpart of this regulation. (Treas. Reg., § 1.351 -1(a)(I)(ii).)

Appellants maintain that the transfers of Benaron and Cowan conform to the terms of this regulation, so the stock of Benaron and Cowan may not be counted toward meeting the 80 percent requirement of section 17463. Therefore, they conclude, the Wilshire transferors

were not "in control" immediately after the exchange, section 17431 is not applicable, and their losses may be recognized. Respondent maintains, conversely, that the transfers of Benaron and Cowan do not conform to the terms of the regulation, so their stock is counted, the Wilshire transferors were "in control" immediately after the exchange, section 17431 is applicable, and no gain or loss is recognized on the transaction.

The regulation relied on by appellants applies only when the primary purpose of the transfer is to enable other transferors to qualify under section 17431. We find that this condition is not met here. Since stock values for purposes of the exchange made it evident that appellants would incur losses, it seems unlikely that any of the appellants, and particularly appellants Benaron and Cowan, would want to structure the transaction so that the losses could not be currently recognized. The losses were obviously beneficial to appellants since they originally reported the transaction as a 'loss on small businessstockrather than a section 1'7431 exchange. Benaron and Cowan have stated that they wished to provide "the most favorable tax consequences possible, including a tax-free exchange if appropriate ...." This confirms that section 17431 qualification. was not the primary purpose of the transfers, but rather just one of the possible tax consequences they hoped to make available to those for whom it would be advantageous. Appellants also state that Benaron and Cowan only made the exchange as a "gesture of good faith in the future value of Wilshire stock to other Lectrabed shareholders." These statements and the obvious advantage to appellants of a recognizable loss convince us that qualification under section 17431 was not the primary purpose of the Benaron and Cowan transfers.

Having found that the primary purpose of the Benaron and Cowan transfers was not that required by the regulation, we need not decide whether the property transferred was of "relatively small value." Appellants advance several other arguments in support of their contention that their losses should be recognized, but we find them to be without merit. The general rule of section 17431 is therefore applicable to this transaction and neither gain nor loss may be recognized.

Appellants also urge that respondent's actions should be reversed because some of the transferors were audited and cleared and then audited again later, resulting in the proposed assessments. We agree with appellants that this procedure has at least some potential for abuse. However, appellants have not pointed out, nor have we found, any prohibition against rcaudits in the statutes or the regulations. Since the proposed assessments were issued within the period of limitations, the second audits are not cause for reversal of respondent's action.

O R D'E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the actions of the Franchise Tax Board on the protests of Martin S. and Audrey B. Appel, Joe and Irene Benaron, and Stephen M. and Patricia S. Rucker against proposed assessments of additional personal income tax in the amounts of $753.84, $4,174.30 and $216.20, respectively, for the year' 1971, be and the same are hereby sustained, and, pursuant to section 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Murray and Janet Cowan for refund of personal, income tax in the amount of $4,046.40 for the year 1971, be and the same is hereby sustained.

Done at Sacramento, California, this 2nd day of March, 1981, by the State Board of Equalization, with Members Dronenburg, Reilly and Nevins present.

Ernest J. Dronenburg, Jr., Chairman

George R. Reilly, Member

Richard Nevins Member

Member

Member